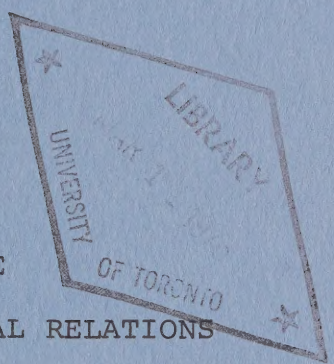
REPORT 3

ON

INSURANCE STUDY



TO

SUPERINTENDENT OF INSURANCE

MINISTRY OF CONSUMER AND COMMERCIAL RELATIONS

ONTARIO

Submitted by
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INTRODUCTION

This is my third report under your instructions to me dated January 30, 1973. This report deals with the other-than-life insurance business and complements Report 1. which was on life insurance.

The purpose of this report is to review problems in the relations between insurers and insureds to see how the rules might be altered to the benefit of the consumer and, if possible, to the benefit of participants in the industry.

My impression is that the other-than-life insurance industry does a satisfactory job in serving the public. But, there are practices that work against the public interest. Many of these practices flow from the structure of the industry. The structure does not adapt because it is held in place by the regulatory system. The structure also creates some frictions and inefficiencies. This report will examine these difficulties. The solution will lie in changing The Insurance Act and Regulations to permit a more flexible structure in the industry.

It would be convenient if the problem could be tackled one by one so that incremental changes could be achieved by making a series of amendments to the Act and Regulations. However, The Insurance Act is in need of so many changes and the problems are so interrelated, that something more comprehensive and integrated is needed. Any comprehensive set of changes will either be a scrambled mess, or it will

reflect, explicitly or implicitly, some policy view on what the industry should look like. I feel the chances of success are better if the policy making problem is attacked as a whole and explicitly.

The main part of this report is a description and analysis of salient functions, practices and roles in the industry, and an analysis of how well The Insurance Act and Regulations fit consumer needs and business realities.

From my inquiries so far, I feel that the consumer's main difficulties lie in three broadly related areas:

1. In the buying and selling process and in the claims settlement process, it is not clear to the insured whose interests the intermediaries represent.

2. Inadequate information on costs and benefits is available to the consumer. The problem includes understandability of contracts, identification of hazards included and excluded and expected benefits and costs.

3. The claims settlement process is hard for the consumer to predict and unnecessarily frustrating for many claimants.

Besides the three main issues mentioned above, there is a range of other problems faced by the consumer; many are consequences of or offshoots from the basic issues.

An example of how the three main problem areas are interrelated shows up when one considers how the selling process and the service that is given on claims are linked. The scope for misunderstanding the terms of the contract at the time of sale is great and clearly this must give rise to many

of the questions concerning claims settlement. The problem is compounded when the insured does not know upon whom he can rely for an explanation.

The interests of insurers, insureds and intermediaries are important enough and conflicting enough to make it advisable to pursue studies of the industry in a very open way. All the issues should come to light before specific changes are adopted.

I want to emphasize that this report, like Report Number 1, can only be regarded as a feasibility study or preliminary overview of the other-than-life insurance industry. While it shows there are problems, it also shows there is a clear need for objective studies of some aspects of the present system. Like the first report, this report is based on information gathered from many sources - interviews and articles, books and other written material. It thus represents an informed viewpoint. However, many opinions in the report are only hypothesis, not fact. The need for further research and broader inputs on many issues is an important recommendation of this report.

In this report, I have focussed on the intermediaries and those aspects of the services of insurers that relate to selling and claims settlement. The insurer's function of managing the underwriting, investment and liquidity has not been discussed except where it had direct relevance to the consumer's needs in the selling and claims settlement processes. This emphasis is the result of my mandate, and

not because the importance of these functions to insurers is not recognized.

The subject of my fourth report will contain a more detailed discussion of possible solutions and of how to implement the conclusions and recommendations in the first three reports.

2. THE ANALYSIS

2.1 HIGHLIGHTS OF THE ANALYSIS

This section summarizes the main conclusions in the analytical section of this report. The numbering indicates the main sections in which the conclusions are discussed.

The Act and Regulations as they now stand

- reinforce the existing industry structure
- inhibit experimentation with and development of new systems of selling insurance and settling claims
- inhibit the development of consulting resources for use by consumers
- contain some provisions which are contrary to the consumer's interest
- fail to require disclosure of some kinds of information the consumer may need

(2.2.2; 2.5; 2.7; 2.8)

Some changes in the Act are needed. Rationally consistent alternatives can be chosen only when a number of policy decisions have been made on the relationship of the regulatory system and industry structure. Policy decisions are needed in the areas of:

- who should be acting for insurers and who for insureds
- price competition on commission rates
- discrimination in prices charged to classes of customers who have different servicing costs
- disclosure of price and product information
- standardization of terms of insurance contracts
- licensing

(2.2.2; 2.6; 2.7; 2.8; 2.10)

The main difficulty for the consumer lies in finding answers to the following questions:

- what are the hazards and the risks of loss he should insure?

- how much coverage should he have ?
- what hazards does the contract cover and what are the exclusions and limitations?
- what expected benefits are included in the amount he is asked to pay?
- which of the contract terms are required by law, and which are there on the insurer's initiative ?
- how can he expect to be treated in making a claim?

(2.2.3; 2.5; 2.7)

The consumer should be able to deal with these problems himself or retain an expert whom he can trust to act exclusively on his behalf.

(2.5; 2.8.5)

An implication of such a change is that differences in premiums must be allowed between different insureds if the costs of serving them are different, and the consumer must be able to choose the level of service he wants to buy.

(2.5; 2.7)

From the differences in services provided, it follows that competition in the fees charged by such advisers will be possible.

(2.7)

The consumer's problems in buying insurance and in making claims are often complex enough that he needs the help of expert intermediaries whose commitment is exclusively to the consumer. Brokers and some independent adjusters might, with some changes in the Act and Regulations adapt to this role.

(2.5; 2.8)

The regulatory system supports an industry structure which prompts intermediaries to act contrary to the interest of the consumer. The bias operates in hidden ways.

(2.2.2; 2.8.2; 2.8.3; 2.8.4)

The other-than-life insurance industry contains many insurers and is not concentrated. There is evidence it is generally competitive in price although it may be less so in selling costs and product innovation. The industry is overwhelmingly dominated by foreign-owned firms.

(2.3.2)

The intermediaries are not only of distinct kinds (exclusive agents(1), general agents(1), brokers, adjusters, consultants and others), but they vary extremely in form and size (from individual agents working as employees to large multinational broker firms).

(2.3.3)

The existence of the agency system, and the purchase of and payment for a service long before use inhibit the flow of market information to the insurers. These obstacles may lead to a lack of adaptation of the product to meet consumer's changing needs.

(2.5)

The needs of individuals and businesses are different enough that the present uniform system may serve individuals at too high a total cost. The regulatory system must be flexible enough to accommodate multiple methods of delivery of service and to allow change in structures to develop.

(2.5; 2.6; 2.8.1; 2.9)

Methods and technology may be available for lower cost distribution systems that could meet the needs of insureds in simple cases. The present regulatory system inhibits this development.

(2.6; 2.8.1)

While complaints most often arise at the time of making claims, a significant proportion of these come from problems involved in the sale, including:

- incomprehensible contracts
- unexpected limitations, exclusions and conditions
- inadequate explanation by those arranging the sale

(2.2.3; 2.8.2; 2.8.4)

There is some opportunity to reduce the consumer's uncertainty by standardization of insurance contracts. Standardization and setting contract terms for minimum protection of consumers should be designed so it does not discourage flexibility by insurers and the development of new terms to meet new needs.

(2.6; 2.7)

There is a need to prescribe some terms of insurance contracts to ensure that the consumer gets minimum protection that is within reasonable expectations according to community standards. This implies the need to change the rules continually, and sometimes rapidly, to put a stop to practices which do not meet these standards.

(2.6; 2.7)

There is need for disclosure to improve the visibility of both the product and its price for a rational choice to be made by insureds. The dollar value of expected benefits and the insurer's mark-up should be disclosed along with information on risk class the insured is placed in and on the selection and claims settlement practices of the insurer.

(2.7)

Members of groups for whom the buying decision is made by someone else, say an employer, are entitled to similar disclosure, since they pay some or all of the premium.

(2.7)

The terminology and role titles in the industry are confusing.

(2.2.3; 2.7; 2.8)

There is role confusion amongst the various classes of intermediaries - exclusive agents, general agents, brokers, adjusters and consultants. The confusion exists in understanding:

- whose interests each class of intermediaries represents
- what agents do that makes them different from brokers and what brokers do that makes them different from consultants

(2.8)

All these groups are compensated by insurers, rather than insureds, creating at least a presumption that they represent the former.

(2.8)

Existing commission systems provide an incentive to intermediaries to act in the interests of insurers rather than insureds when the two interests diverge.
(2.8.2; 2.8.3)

The practices of insurers and adjusters in claims settlement both appear to need regulation.
(2.2.3; 2.8.4)

It seems difficult to see why the conduct of independent adjusters should be regulated and that of company adjusters should not or why marine adjusters are not licensed at all.
(2.8.4)

Where there is a dispute on claims between the insurer and the insured the contest is an unequal one.
(2.8.4)

Greater use of the arbitration system that already exists in the Act should be promoted.
(2.8.4)

Any person who is engaged in an occupation for compensation or carries on a business of claims adjustment or assistance related to the automobile collision or automobile property damage field which is now outside the regulation of The Insurance Act, should come under the regulatory system as adjusters.
(2.8.5)

The licensing system should be tailored to meet explicit objectives. For different segments of the consumer market different objectives are appropriate. Therefore, at least a two-step licensing system seems necessary.
(2.9)

Both companies and individuals (whether employed or independent) should fall within the regulatory system. For some purposes, individuals may be controlled for competence as well as conduct, in order to supplement the controls that are required for corporations. The corporation can only be effectively controlled as to its conduct.
(2.10)

The establishment and maintenance of appropriate standards of qualification and conduct, and the administration of these, is a continuing process that needs to be tuned to both the public's expectations and the industry's capabilities.
(2.9; 2.10)

2.2 PRESENT REGULATORY SYSTEM AND INDUSTRY PRACTICES

2.2.1 Background

The present regulatory system has grown bit by bit over the years. In its origins it appears to have been designed to reflect the best industry practices and structures of the times. In recent years the Act and Regulations have had numerous amendments and interpretations that have been desirable because they prohibited practices that some insurers had adopted to the detriment of the public. There will continue to be the need for a stream of changes of this kind as insurers and intermediaries in the system jockey with one another for competitive advantage, and the public's attitude on what are acceptable practices evolves over time. Thus, even if an ideal set of rules were established right now, one could expect the need for a continuing flow of changes to start again within two or three years. One can conclude that there is a need for an administrative structure which can respond quickly with new solutions to problems as they arise, and which is staffed to handle problems of fine detail in considerable volume.

Another important aspect of the present regulatory system is that it perpetuates existing industry roles and structures, and prevents adaptation and experimentation in structure to meet changing needs. Some industry roles are structured in ways contrary to the consumer's interests. To the extent that the regulatory system preserves a structure with these results, it should be changed. Simply replacing

the present structure with a new prescribed set would seem to be inappropriate. The new set would in turn soon be out of date. Furthermore, to expect a regulatory system to prescribe the structures assumes an ability which probably does not exist - the ability to define a best system for the distribution of insurance.

The following two sections in this report outline some of the main problems raised by the present regulatory system and industry practices.

2.2.2 Problems in The Insurance Act

In my first two reports to you and in oral discussions, I indicated that there are some serious problems with the Act and Regulations as they now stand. The problems fall into three categories.

1. The Act and Regulations contain some provisions that are contrary to the interests of consumers, and do not contain certain provisions that would be helpful to consumers. They also contain provisions governing transactions and the roles of the participants which do not fit the realities and practices.

2. There are sections which are inconsistent with one another, or which appear to serve no useful function or which are subject to conflicting interpretations.

3. There are other sections having mainly to do with the administration of the Act which are inconsistent with the current philosophy and practice of administrative law in Ontario.

Where changes of substance in present provisions are required, few revisions can be proposed independently of an overall policy on what the Act and Regulations should accomplish. It is on these problems of policy that this report focusses.

The main inconsistencies in the Act and Regulations and the outdated administrative provisions were the subject of Report Number 2, which you have already received. They were dealt with separately because they can be seen as independent of insurance regulation policy. It should be emphasized that Report Number 2 was not intended to be comprehensive, but rather a list of matters upon which you might choose to act separately.

The main issues in the present regulatory system that appear to pose problems are:

- Competition to reduce selling costs or improve the selling system is impeded by provisions of the Act governing sales commissions:
  - prohibition of rebates
  - apparent prohibition of extra charges made to the purchaser
  - apparent requirement that remuneration be paid only by the insurer
- The rules defining roles and sources of payment for agents and brokers impede development of classes of individuals or firms who can act on the buyers behalf.
- Nomenclature that is confusing to consumers is given sanction by the Act and Regulations.
- By putting the requirements for the form of insurance contracts, or part of the contract, into the statute, the process of making changes beneficial to the consumer may be made more difficult and cumbersome than it needs to be.
- A uniform standard of qualification for the licensing of agents does not recognize the needs of different classes of buyers. A single standard imposes higher costs where needs are simple and offers inadequate assurance of skills where needs are complex.

The organization of The Insurance Act is difficult to follow. When the problems and inconsistencies have been cleared up, when appropriate administrative practices have been chosen and when the substantial problems outlined above have been resolved, there will remain a need to have the Act reorganized so that its structure is more logical.

2.2.3 Industry Practices and Problems

As with the life insurance industry, I have heard of a long list of problems, practices and complaints in the other-than-life field. These problems have not been verified in a statistical or objective way, but for most of them there is evidence they are real and significant. The principal ones are:

(a) Historically, there have been some attempts to fix prices in the industry. Price fixing does not at this time appear to be operative. However, there appears to be a continuing threat to consumers that bears watching.

(b) Many policies are virtually unintelligible, even to people accustomed to legal phraseology.

(c) The purchaser has no simple way of comparing the price and the nature of the service offered.

(d) The consumer has no accessible evidence of the insurer's claims settlement policies or practices other than word of mouth or the agent's opinion. While the agent's opinion may be helpful, his experience is limited to those companies with which he deals regularly. He may also be subject to bias because of the commission structure.

(e) There is a variety of information agents sometimes do not tell the insurance buyer about:

(i) What hazards are covered? How significant are they? What hazards are specifically excluded?

(ii) What are the factors on which a claim might be denied; for example, the effect of a dwelling being unattended for over 96 hours in the heating season.

(iii) How should he protect himself from hazards not covered by the policy? What additional coverage might a prudent person obtain?

(iv) How should he estimate the amount of coverage he needs, and when should he revise it?

(v) How will his claim be calculated if a loss occurs?

(f) The terminology used in the insurance industry is itself misleading to a layman: the word 'comprehensive' is used when in fact there are exclusions or restrictions in the contract; the word 'agent' means salesman; the word 'premium' means amount to be paid by the buyer.

(g) Your Department's experience and the McWilliams Report have already identified for you numerous problems in the area of claims settlement. This report will not go over that ground in detail, but here are a few examples of the claims settlement problems:

(i) Adjusters sometimes convey to insured and third party claimants the impression that they are referees rather than agents of the insurer. This is particularly a problem where the adjuster can introduce himself as an 'independent adjuster'.

(ii) Some claims settlement officers urge fast settlement with a release. This may prevent the insured from having time to develop his claim to its full potential.

(iii) Insurers sometimes do delay payment of claims unreasonably. Once a claim has been settled, the amount of the claim belongs to the insured; but the insurer may have little incentive to pay the claimant quickly.

(h) Some independent adjusters claim that they are unable to attract and keep competent people to their business.

(i) Brokers and agents are unable to charge buyers a fee in addition to commission for extra work that has been done.

(j) The agent or broker is unable to charge a lower commission or give a rebate to a customer even though he has done less work and is willing to accept lower compensation.

(k) The agent or broker gets paid the same commission for renewals as for his initial work on a policy.

(l) Occasionally agents receive commissions for doing no work at all.

(m) A broker sometimes receives a commission in excess of what he agreed to with the client, and then does other work up to the amount of the unearned commission without further charge. If the value of the work is less than the amount of the unearned commission, the broker takes it into his income at the end of the year anyway.

(n) An employer who holds out to his employees that he is contributing to group insurance plans is not required to disclose to the employees how much his contribution is. After experience rebates, the contribution may be quite low and there is nothing in the system which prevents him from receiving rebates which are in fact a return of part of the employee's contribution.

No doubt many of the above can be explained by the nature of the business. However, it is difficult to escape the conclusion that it must be possible to devise ways to overcome many of these problems.

2.3 INDUSTRY STRUCTURE

2.3.1 The parts of the industry

The main participants in the other-than-life industry are identified in the following chart. Examples of the flow for key transactions between participants are shown by the arrows:

- Sales of insurance contracts to consumers are made through exclusive agents or through general agents or through brokers, all of whom are licensed. (Agents and brokers may have employees who are licensed salesmen.) Some sales are made directly to consumers as a result of advertising in print media (mass merchandising).

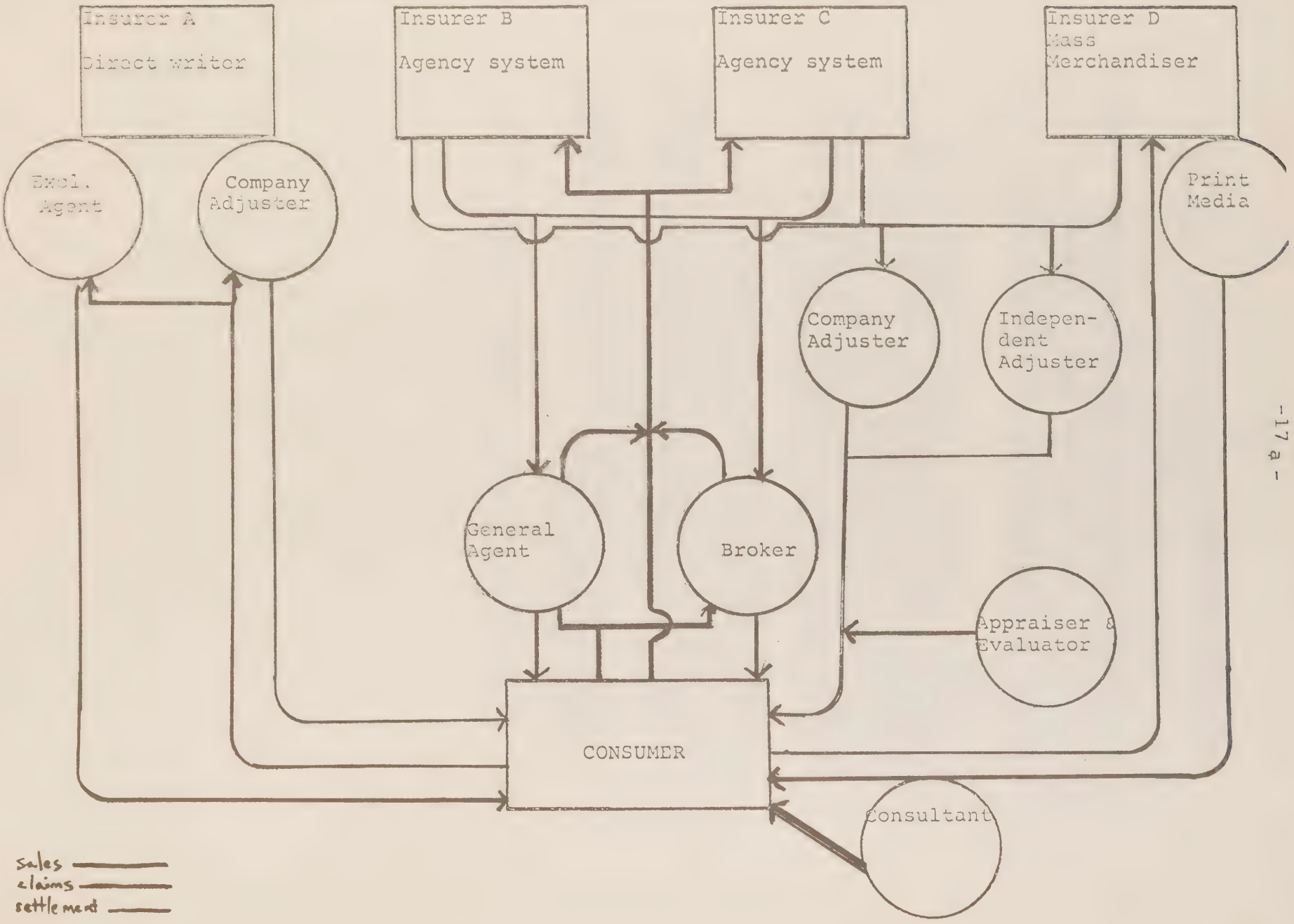
- Claims may be initiated by going direct to the insurer or going through a broker or agent.

- Settlements are made through adjusters employed by the insurer (not licensed) or through independent adjusters (licensed) retained by the insurer.

- Appraisers, who are not licensed, may be retained by the insurer or adjuster to help in establishing values for settlement.

- Advice on the consumer's buying decision may be given by consultants who are not licensed.

Participants in Other-than-life Insurance Industry
and Alternative Flows for Main Transactions



2.3.2 Insurance companies

For perspective, it is helpful to start with some size characteristics of the industry.

The total premium income for other-than-life insurance in Ontario in 1972 was just over one billion dollars, almost the same as for the life insurance industry. This figure is equal to about 2% of the GNP of Ontario and to about one-sixth of the annual revenue of the Provincial Government.

The value of assets controlled by other-than-life insurance companies is slightly less than one-fifth as much as that controlled by life insurance companies. The relative size of assets under control of all financial intermediaries in Canada in 1968 was as follows:

DISTRIBUTION OF ASSETS OF FINANCIAL INTERMEDIARIES IN CANADA 1968(2)

Private Sector			
Chartered Banks		28.9%	
Private non-bank institutions			
► Life insurance companies	13.6% ◄		
Pension funds	8.9		
Trust Companies	5.0		
Consumer loan & finance companies	4.9		
Credit unions	4.2		
Mutual funds	3.4		
Building societies & mortgage loan companies	3.0		
► Other-than-life insurance companies	2.5 ◄		
Other intermediaries	2.2		
		47.7	
			76.6%
Public sector (Bank of Canada, CMHC, CPP, provincial saving institutions etc.)			23.4
TOTAL			100.0%

Both segments of the insurance industry derive funds for investment from receiving annual premiums in advance, and from capital and retained earnings belonging to shareholders (to policyholders in the case of mutual companies). Life insurance companies have more funds for investment in proportion to premiums received because of the savings component in ordinary life insurance policies and annuity and pension funds.

Clearly the other-than-life insurance industry is a significant factor in the province's and the country's economy whether measured in terms of either funds flowing through or assets. It is such a large industry that even small improvements in efficiency would yield large aggregate dollar returns. About 65% of annual premiums in the other-than-life segment is paid out in settling claims. This leaves about 35%, or $350 million to cover profits and the costs of operating the industry. An improvement in efficiency of only 1% would amount to $3.5 million at the level of 1972 premiums. A major portion of these costs are in selling. Commission rates alone in auto and property insurance range between 7% and 25% of premiums, with more business done at the higher end of that range. It seems reasonable to hope the industry might increase its efficiency if the regulatory system were altered to allow competitive pressures to be exerted more effectively on selling costs.

The number of companies in the other-than-life insurance business, and their distribution by size, show some interesting contrasts with life insurance. There were in 1972 approximately

270 companies carrying on the other-than-life insurance business, compared with about 130 life insurance companies. The distribution of business among the two groups in Canada was approximately as follows in 1972:

	Proportion of Total Premiums Accounted for by the Largest Companies in Canada (3)	
	5 Largest	15 Largest
Life Insurance	39%	76%
Other-than-life Insurance	20%	38%

This crude measure shows much greater concentration in the life insurance industry. It should be mentioned that while there are 270 corporations registered to do other-than-life insurance business in Ontario, a number of these are associated by ownership into groups of insurance companies. One estimate is that most of the business is done by about 50 such groups or independent companies; another source estimated about 80. This does not alter the broad conclusion about concentration, but it does alter one's perspective on the number of significant economic entities being regulated.

In Report 1, I concluded that one might hypothesize that the life insurance industry was not very competitive on price, especially on individual ordinary life policies. The difference in concentration between the life and other-than-life insurance segments suggests that one might consider a different hypothesis for the other-than-life industry. In 1974, the Insurance Bureau of Canada published a sponsored study entitled

Competition, Economic Efficiency, and Profitability in the Canadian Property and Casualty Insurance Industry, by Professor G. D. Quirin et al. of the University of Toronto. The authors of this study concluded that the other-than-life insurance industry is competitive on price and productivity. Two areas where the authors suggest there may be limited competition and efficiency is in selling costs and in the development of new products. They attribute the lack of competitiveness in these areas to the effect of existing regulations. From my own examination of the regulatory system and observations on the industry, I believe their hypothesis has merit. Given the validity of the Quirin hypothesis, then, changes in the regulatory system to encourage more efficiency in distribution and in development of new products would likley result in cost reductions or service improvements being passed on to consumers.

The industry is overwhelmingly foreign controlled. In 1969 over 80% of premiums in Canada were written by foreign companies operating in Canada (50%) or by Canadian companies that are subsidiaries of foreign companies (30%)[4]. Many of the practices of companies operating in Ontario may be transferred from what is customary in their home countries, mainly the U.S. and the U.K. This also accounts for the survival of the large number of companies who are active in the Province in a small way; the marginal costs of a large foreign company operating here on a small scale could be quite small.

There is one noteworthy benefit from the participation of a number of large foreign companies in the insurance industry here. It provides access to international markets for coverage of large amounts or difficult or unusual risks.

2.3.3. The intermediaries

The various groups of intermediaries and their estimated numbers in Ontario are:

- Agents	
- exclusive	
- sell for only one insurer employed on commission and/ or salary	3,000
- general	
- selling for several specific companies on commission (includes 100-200 who compete significantly in the sales of group plans)	5,000
- salesmen	
- employees of agent, not on commission	not available
- Brokers	
- placing insurance with insurers	
- as companies	20
- broker employees of broker companies	100
- sales employees of broker companies	350
- Adjusters	
- investigating and evaluating claims for insurers	
- exclusively acting for one company as employee	not available
- independent, acting for any company, excluding trainees	1,000
- Consultants	
- actuaries assisting buyers to design and buy insurance contracts (including group life)	
- firm owned by or associated with a broker or agent (some employees in the firm are usually licensed to sell life insurance and are sponsored)	10-20
- independent firms, not licensed in any way	10-15
- others assisting in design and buying of insurance plans	5-10

- Evaluators, appraisers or experts
  - providing specialized knowledge or information for purposes of insurance claims
    - exclusive occupation — not available
    - incidental occupation — not available

Notes:

1. The numbers above are only approximations in order to illustrate relative magnitudes. Accurate figures are not readily available in all cases.

2. Licenses are required for the categories of life insurance agents, other-than-life insurance agents, brokers' and agents' sales employees, and independent adjusters.

Agents are by far the most numerous group, and their group experiences a relatively high turnover. Exclusive agents are generally employees of insurers working as commission salesmen, although they can be incorporated businesses. Most general agents operate as incorporated small businesses with one or two clerical employees. A small proportion of general agents are larger firms employing salesmen and indistinguishable in size and behaviour from brokers. Agencies generally appear to be locally owned and oriented.

Brokers are few in number, but large in dollar volume. The two largest are reported to have 100 to 200 employees each in Ontario Most of the large brokers are foreign controlled. This may be seen in part as an example of the trend of business service industries serving multi-national corporations to follow their customers. To the extent it is so, it is a reflection of the nature of foreign ownership of industry in Canada and the world-wide growth of multi-national corporations. It is paralleled

by the trend to foreign ownership or international associations of other financial services such as banking, investment dealers, management consulting and auditing, where ownership controls have not been imposed by government intervention.

Except in some limited ways competition on price is not a factor among sales intermediaries. Agents and brokers are prohibited from competing on price except on 'one-of-a-kind' policies such as group accident and sickness, or group life plans. However, brokers and some general agents are instrumental in inducing price competition among insurers because of their practice of shopping for a low premium for an insurance buyer. The principal focus of competition is on this and other services offered to the consumer.

Adjusters are organized similarly to general agents - mostly in very small local businesses, with a small number in larger national firms. The main competitive factor impinging on independent adjusters is the insurer's option to do the work with its own employees.

Consultants who are not actuarial consulting firms associated with brokers tend to be small businesses with not more than a few individuals each.

Evaluators, appraisers or experts specializing in insurance matters tend to operate in small firms. Those for whom work on insurance matters is incidental to their main occupation, are usually retained for their personal expertise, regardless of the business organization within which they work. The major exception is a few major firms specializing in real estate and business equipment appraisals.

2.4 The Role of the Insurer

The essence of what the insurer does is to take from the insured the risk of loss from defined causes or hazards. In playing this role the insurer performs several functions:

1. He assesses the probability of a hazard occurring to participants in a pool and puts a value on the risk of loss.

2. He organizes the pool by:

   (a) soliciting others to join

   (b) collecting and administering money from each insured in the form of a premium

   (c) providing his own capital which acts as a cushion in the case of an underestimate of the probability or amount of a loss

   (d) investing funds provided by premiums and by capital to yield an additional flow of funds

3. He satisfies the claims of or against insureds for losses by paying out money when losses occur.

4. He protects the pool by refusing to pay claims for losses where not covered under the contract or the part of claims that is greater than the loss incurred.

These last two functions are to some extent opposed and give rise to difficulties. The claimant with a loss will seek the most generous possible interpretation of the contract. The insurer has an incentive and indeed a duty, to interpret the contract more judiciously. He should judge the claim in accordance with the claims settlement policy planned when the contract was sold. Where the claim is straight-forward the insurer has some motivation to satisfy it because each satisfied claimant makes it easier to solicit new insureds to maintain the pool in the long run.

Of course, when the claim clearly falls outside the contract, or is fraudulent, all insurers will deny it. All claims must be given at least a cursory examination from that point of view.

Where terms, facts or values are in doubt, some insurers follow more rigorous interpretations than others, with a view to reducing or denying claims. Those with more generous practices in this respect must reflect this in the expected losses estimated in setting premiums, or must compensate in their selection of insureds.

The conclusion to be drawn from this analysis is that no amount of regulation can eliminate all sources of friction between insurer and insured.

On the other hand, there are many practices insurers adopt in the settlement of claims which are at least a nuisance and at worst outrageous. Some of these are referred to in Section 2.2.3 'Industry Practices and Problems', and Section 2.8.4 'Insurance Adjusters' enlarges on the background to the problems. But there are many other undesirable practices and no doubt new ones will always turn up.

Insurers should have freedom to use a variety of practices on these difficult claims issues and try new ways of dealing with them. To define desirable kinds of practices, and to put a stop to the undesirable requires a regulatory authority that is in close constant touch with the scene and that is capable of fast response.

2.5 THE CONSUMER'S NEEDS

The basic need of the insured is to have someone else (the insurer) take from him the risk of catastrophic loss. There are sometimes important differences between this basic need and the nature of the service offered:

- Sometimes certain kinds of losses are excluded from the contract or there are severe limitations on the circumstances under which a claim for loss would be allowed.

- Sometimes the contract provides for upper limits to the insurance coverage so that the insured is not protected against the catastrophic impact of big losses.

- Sometimes the contract offered covers the total loss, with small or no deductible amounts allowed for which the insured can take the risk himself.

It should be pointed out that in spite of the differences mentioned above, a determined buyer of insurance can nearly always get his needs met from some insurer at a price. The range of hazards that one can insure against has to be one of the amazing accomplishments of the insurance industry, partly the result of its international character. But the issue for the ordinary buyer of insurance is not what he can buy with a special and informed effort, but what is available to him in the normal course from insurers.

How can one say with any assurance that specific needs of consumers are not being met by the industry? There simply is no way to get conclusive evidence on such an hypothesis by objective studies. What can be done is to analyze whether there are structural conditions which inhibit industry adjustments to meet the apparent needs of consumers.

Normally a divergence between the seller's and the purchaser's perceptions of the characteristics of a contract is self-correcting through the information structure in the market system. In the other-than-life insurance industry, this self-correcting mechanism is inhibited by five characteristics of the industry:

1. The agent, whether exclusive or general, for the most part 'sells' those contracts the insurer has to offer and defines the buyer's needs in terms of these pre-existing contracts, rather than 'shopping' among insurers to find a contract more appropriate to the buyer's needs.

2. The buyer does not have a knowledge and understanding of what he 'should' have, of what is actually included in any given contract of insurance, and of what is potentially available from insurers.

3. The organizational division between the selling of insurance and the service of claims separates those who have knowledge of the buyer's needs through claims experience from those who are offering him a contract.

4. There is a gap in time between the selling of the contract and the delivery of service on a claim which further tends to inhibit a matching of buyer's needs and seller's offerings.

5. The fact that the service is paid for before it is delivered also reduces the incentive for insurers to reconcile their offering with consumer's needs. For tangible products, the consumer has something he can see and which he may be able to return if he finds it does not meet his needs. Where he is unable to return the item, the cost is often so small that the risk of trying the product by consuming it is insignificant. For most services, a buyer with reasonable credit standing can expect to have the service completed so that he can assess its quality before he pays for it. Insurance is, by its nature, paid for in advance of the service being rendered.

This analysis suggests that one objective of changes in the regulatory system might be to improve the mechanism for reconciling consumer needs and product offerings on a continuing basis.

Besides those consumer needs satisfied by the insurer, there are other needs satisfied by intermediaries. At the time of the sale of insurance, the consumer requires assistance on a number of matters which include:

- identification of risk
- establishment of procedures to minimize risk
- identification of the kinds of coverage that would be appropriate (including the specification of non-standard forms of coverage)
- obtaining quotations from insurers on specified coverages
- evaluating the differences in contracts offered by different insurers
- negotiating the terms and price of specialized contracts
- placing the insurance with particular insurers.

In the claims settlement process the consumer's needs include:

- proving a loss occurred
- establishing that the loss was covered by the contract
- evaluating or appraising the amount of the loss
- filing the claim
- negotiating a settlement with the insurer in the case of a dispute.

To satisfy both sets of needs there must be information available and accessibility to persons possessing the knowledge of how to use or manipulate it. It has been customary in the insurance industry for the intermediaries discussed in this report (agents, brokers and adjusters) to provide part or all of the information to consumers.

There have been two developments which cast doubt on whether the roles as presently constituted meet the variety of the consumer's needs efficiently.

1. At one extreme there has developed mass merchandising in print media and machine sales of insurance. This suggests that some insurance needs are being met in very simple ways. Applications of computer technology, standardized contract terms and disclosure, and availability of the branch systems of banks, trust companies and credit unions, suggest the possibility of devising new low-cost distribution systems. At present, the regulatory system inhibits this kind of development. New delivery systems might allow the consumer to 'do-it-himself' in using information to meet many of his needs.

2. At the other extreme, unlicensed consultants' services have developed. Some of these offer services more expert than those of conventional licensed intermediaries. To make this service effective, they must be able to use, and therefore must always have, the maximum amount of relevant or reliable information. Part of their expertise lies in obtaining, interpreting and using such information.

The foregoing analysis of consumer's needs has dealt with the needs of general consumers. There are, however, at least two major segments of insurance consumers: institutional and business consumers on one hand, and individual (personal) consumers, on the other. Approximately three-quarters of all insurance premiums are paid for the benefit of individuals while one-quarter are for the benefit of businesses and institutions. Since much of the accident and sickness insurance on individuals is sold through groups administered by a business or institution, only about 55% of total insurance premiums is from sales directly to individuals. Most of the sales to individuals are for auto and property insurance.

The major needs of these two market segments differ. Businesses and institutions need:

- Coverage which must be tailored to meet the needs created by a great variety of conditions.
- Advice on how to rearrange the organization's affairs to reduce risk of loss.
- Detailed price information so that shopping and bargaining can be effective.

These matters are of importance because premium costs are large enough to justify the time spent on controlling and reducing them.

The primary needs of individuals buying insurance for themselves are:

- A feeling that what they pay and what they get is not seriously out of line with what other individuals pay and get.
- Low costs achieved from the economies of scale in handling repetitive standard transactions.
- Simplicity and convenience in meeting complex needs.

Obviously this categorization is only a simplified representation of divisions in the marketplace. In fact, the needs described above are a continuum, with very large businesses at one end and individuals who are buyers of small policies at the other. In between are wealthy individuals who have needs similar to those of businesses, and small businesses which have some of the needs of individuals. Identification of two major groupings of needs is useful because it suggests that the regulatory system must be flexible enough for more than one distribution system to develop, if maximum efficiency is to be achieved.

To recapitulate, here is a summary of the main conclusions that can be drawn from the foregoing analysis of consumer's needs:

1. Difficulties that arise in the claims process are linked to the selling process.

2. The regulatory system has to allow for flexibility in contract terms and distribution systems to meet continually changing needs.

3. The regulatory system has to allow for variety in the terms of contracts and in the methods of distribution to meet the needs of different classes of consumers.

4. Thre is a need for some standardization of contract terms to help the consumer understand what is available to him and to make him feel he is adequately protected.

5. In both the insurance buying and insurance claims processes the consumer has a need for intermediaries who will represent his interests and provide expert help.

2. 6 SERVICES OFFERED

From the point of view of the insurer, the nature of the service is that for receipt of an amount (the premium) he offers a contract to pay for a loss up to a stated maximum amount. The losses are usually defined in terms of losses from specific causes or events occurring within a period. The loss may be property itself, the use of property or future income.

The most important characteristic of the insurance service for the insured is that he know that events which might produce a loss are covered by the contract he takes out. Hence the importance of the understandability of contract terms.

Another important characteristic of insurance from the insured's point of view, is the reliability of the insurer's promise to pay. Regulation for financial reliability in the insurance industry has been a longstanding success story so that there has been no consumer problem in this area. Some current trends suggest it may be time to consider whether the adequacy of the present liquidity rules deserves re-examination by you and/or the federal authorities.

There are fifteen classes of insurance used in licensing insurers. The following summarizes the relative importance of the classes by premium dollars in Ontario in 1972. Four classes account for 95% of total premiums. These must be the areas of primary concern for this study and for the Department.

Classes of Insurance Premium Dollars and Number of Companies Licensed for Each Class Ranked by 1972 Premium Dollars in Ontario (5)

Classes of Insurance	Premiums ($ millions)	% of total premiums	Cumulative % of total premiums	Approximate number of companies lice
Automobile	$ 490.2	45.4%	45.4%	260
Property	265.6	24.6	70.0	170
Accident & Sickness	222.8	20.6	90.6	170
Liability	52.6	4.9	95.5	220
Surety	10.7	0.9	96.4	100
Boiler & machinery	10.7	0.9	97.3	90
Marine	10.3	0.9	98.2	80
Fidelity	5.0	0.5	98.7	110
Aircraft	4.5	0.4	99.1	40
Mortgage	3.9	0.4	99.5	1
Hail	2.7	0.3	99.8	30
Credit	.3	0.1	99.9	4
Title	.8	0.1	100.0	2
	$ 1,079.6	100.0%	100.0%	

This classification is the result of industry tradition responding to changes in regulatory requirements, customer needs and law on rights of recovery for losses. It will be noted that some classes are identified by the nature of the asset around which the loss occurs (e.g. automobile, aircraft, marine, property) while other classes are identified by the nature of the event that gives

rise to the loss (e.g. accident and sickness, liability, fidelity, hail). This is untidy conceptually amd statistically but it fits industry practices for gathering data. It is an illustration on a very broad level of how industry terminology can confuse. Is the householder covered for liability claims under his property insurance contract or does he need separate liability insurance? Under which class is it reported?

The relative importance of the classes of insurance has not remained constant over time. Newfeld points out that in 1875 fire insurance accounted for 96% of premium dollars.(6) Improved fire protection services and the growth of other hazards and new kinds of property (e.g. automobile) have led to significant shifts in the importance of classes of insurance.

For some classes of insurance, contracts are written by the millions and for relatively small amounts, especially in personal lines. For some classes, like auto, standardization has been imposed by law. For other classes like fire insurance, parts of the contract are standardized by law and other parts by industry practice. At the extreme, some like title insurance have so few insurers, or like marine and aircraft are so specialized, that standardization is not an issue. For an unusual risk a unique contract may be written. If insurance classes were ranked by degree of standardization the ranking would be roughly correlated with the ranking by premium dollar volume. However, in each class there will always be some need for customized contracts. As a result total standardization would prevent some needs from being met.

There are two ways that an insurer can change the nature of the service he offers to meet competitive conditions:

1. He can identify different levels of claims for any given hazard with different classes of insureds to whom he charges differential premiums.

   -A simple example of this process is, if people in community A have higher fire losses than in B, the insurer may leave his premiums the same, but not accept contracts from community A or he may offer coverage to community A for a higher premium than in B.

2. He can change the definition of the hazards he insures against.

   -Some insurers seek competitive advantage by broadening their coverage; others seek to limit claims by narrowing their coverage.

A number of factors continually lead to changes in the customary form of contracts. Changes in society and technology create new hazards (e.g. nuclear radiation); judicial decisions extend or restrict the meanings of insurance terms.

Common consumer needs, competition and industry tradition have led to a degree of standardization or common practices sometimes supported law, and in other cases adopted voluntarily within the industry. Standardization of the terms of contracts offers two important advantages.

1. The need of consumers to understand their position and to feel fairly treated are in part met by standardization of some or all of the terms of commonly used kinds of insurance. Each consumer does not then have to understand a contract in detail to be satisfied that he is getting a normal kind of coverage for his kind of problem.

2. The consumer needs protection from particular insurers who write or interpret contracts to their own advantage in ways that are not acceptable to the public or to the trade (e.g. an employee who lost sickness insurance coverage when a group changed coverage from one insurer to another; or a manufacturer who loses product liability coverage for products in the field but not found faulty until after the term of insurance expires).

The need for understanding and reassurance demands some standardization of wording of contracts in commonly used kinds of insurance; on the other hand, the need for minimum protection demands continual changes in a standardized contract.

In the light of the need for changes in the terms of contracts, the present system appears rather cumbersome. Amendment of the Act and Regulations is a slow process and dependent as to timing on many variables some of which are outside the control of the Superintendent. Furthermore, changes (and even the promulgation of guidelines) usually are preceded by lengthy consultation through the Association of Superintendents of Insurance of the Provinces of Canada in order to achieve national uniformity.

It would seem that the use of a body in which the industry takes some responsibility and into which there was strong input from consumer interests might produce better standardization, and might improve the speed with which bad contract terms get changed in the consumer's interest. The question is, could such a body operate within a legal framework which gives

it power to define standardized terms? Even if a responsive and responsible body could be established to make standardization more effective, it should be constituted and operated so as to permit adaption and innovation by individual insurers.

2.7 DISCLOSURE - PRICE AND OTHER INFORMATION

In ordinary usage the price of an insurance contract tends to be equated with the premium. For analytical purposes this is not adequate. Because the concepts to be discussed here are uncommon ones, the terminology to be used requires definition:

'Premium' is the total payment required from the insured by the contract

'Expected benefit' is the portion of the premium that is the insured's contribution to the risk pool held by the insurer

'Mark-up' is the difference between the premium and the expected benefit.

The 'expected benefit' of an insurance contract is usually the larger part of a premium. On average, it is estimated to be about two-thirds of the premium, but there is evidence the proportion varies greatly.

One formula definition of the 'expected benefit' helps understand the 'expected benefit' of a contract in terms of the pool for a given risk class:

$$\text{Expected benefit} = \frac{\text{Total amounts the insurer expects to pay out}}{\text{Total premiums the insurer expects to receive}} \times \text{A particular premium charged to a member of the risk class}$$

From this it can be seen that 'expected benefit' is a particular insured's contribution to the risk pool, from which claims will be paid.

Another expression describing the same amount casts a different light on the nature of the 'expected benefit' for a given risk class:

Expected benefit	=	Probability of a loss	X	Expected value of a loss that may occur

where the 'Expected value of a loss that may occur' is not greater than the 'insured value' and is reduced by the 'deductible amount'. This expression underlines two skills an insurer needs in rating - the ability to estimate the probability of a loss, and the ability to estimate the expected value of any loss that may occur. An additional related skill is the ability to examine the position of the insured and decide what risk class he should be in.

The 'expected benefit' then is a result of rating and the placing of an insured in a risk class, and it is the insured's financial contribution to the pool. It is the insurer's measure of the insured's risk of loss. It is also the object or value of the financial service an insured buys. Therefore, it is essential for a rational buyer of any class of insurance to know this amount. The need has been recognized in the case of accident and sickness insurance in the August 1, 1974 Report of the Standing Committee on Accident and Sickness Legislation of the Association of Superintendents of Insurance of the Province of Canada, and proposals of the CAASI discussed therein. One proposal calls for the 'anticipated loss ratios' (which is equivalent to 'expected benefit' as a proportion of the premium) to be disclosed for accident and sickness contracts.

Three important conditions would affect a buyer's evaluation of the expected benefit for any class of insurance:

- the risk class the insured is placed in by the insurer
  - a low risk class has a lower probability of loss and thus lower expected benefits

- the stringency or liberality of the insurer in accepting an insured within a given risk class
    - stringency would reduce the possibility of loss and thus the expected benefits
- the stringency or liberality of the insurer's claims settlement practices
    - stringency would reduce the estimated value of the claims paid out and thus the expected benefits.

Whether higher or lower expected benefits are desirable or not depends on the combination of the insurer's practices and the consumer's circumstances. To make an optimum choice the consumer needs objective evidence on these conditions from which he could make his own estimates in order to make a trade-off decision. The risk class the insured is placed in is certain and can be disclosed directly. For the other conditions direct and certain evidence cannot be made available, although some indirect evidence could be.

The insurer's mark-up is the premium less the 'expected benefit' described above. Out of the mark-up the insurer expects to earn a return on his investment after paying his operating costs plus his net claims loss and after receiving his investment income and net claims gain. The insurer's ability to manage these variables has an important effect on the insured through the single figure, the mark-up. Because of the differences in the forms of organization and the competence of insurers, the mark-up can vary from company to company. One can look on this mark-up as the price or 'commission' paid to the insurer for the basic service or product.

It would seem inequitable for two insureds who get the same service from an insurer (e.g. advice on coverage and policies required and on how to reduce risks) to pay different prices, that is,to face different mark-ups. It is equally inequitable for those requiring different services from the insurer to have to pay the same price. For instance, if one insured makes himself less costly for the insurer to deal with by getting a broker to help identify his needs and to write up the application, it is hard to see why he should have to pay as much as another insured who uses the insurer's resources for this function.

Disclosure of the mark-up separately from the expected benefit, combined with the ability of an insured to negotiate separately with a broker on a buying fee,could lead to price competition in some useful new ways. Brokers could compete amongst each other on fee and service; insurers could compete amongst each other on mark-up and service; and with the unbundling which should result there would be competition between brokers and direct-writing insurers on price and service in the distribution of insurance. At the same time, consumer behaviour with respect to expected benefits could be expected to be different since the consumer could see the 'product' much more clearly. He could come closer to being able to choose the trade-off combination of expected benefit, risk class, risk selection practices and claims settlement practices that suits him. Some consumers would choose to pay more for a greater expected benefit. As a result

the present competition on premium which exerts pressure towards lower expected benefits would be converted to competition to reduce mark-ups and to reduce selling costs.

Product information needs of the consumer include more than what has been mentioned so far in this section. Drawing on the earlier analysis of consumer needs, information in understandable language is also needed on:

1. What accidents or events the insured is covered for.
2. What the insured is not covered for, including a clear statement of how he might lose coverage.
3. How the insured's loss claims are to be calculated and verified.

Standardization may have helped give a feeling of security to the insured but it seems to have done little to add to his understanding. The kind of language used and the multiplicity of conditions and exceptions, even in standardized contracts, need simplifying. Since a standardized contract will not do for all consumers, perhaps the contracts should be designed so that,in relation to a standard, both more extensive benefits and coverage and more restrictive conditions and coverage are clearly identified and labelled as such.

There will be strong arguments raised against disclosure of the kind of information discussed above. The arguments will have a fimiliar ring to those who have lived through the earlier battles on disclosure about financial statements of corporations and sales of securities and about interest rates.

It will be evident to most observers that separate disclosure of 'expected benefits' and 'mark-up',(i.e. the product and its price) will not be harmful. That the information is difficult to understand and that it may not be used by many consumers is irrelevant. The availability of the information will enable some consumers and their expert advisers to use the information in buying decisions. The resulting competition can be expected to lead to improvements in the mix of product quality and price available to consumers.

So far we have discussed the problems of the consumer buying for himself. There is a great deal of group insurance that is bought for consumers by someone else, for instance an employer, a creditor or an association. In these cases the choice of contract, the amount of coverage and the negotiation of the amount to be paid, may all be out of the control of the consumer although he may be asked, or be required, to pay all or part of the premium. Disclosure to him along the lines discussed above, is not directly relevant to a choice available to the group member. However, the buying has been done ostensibly on the group member's behalf. It would seem appropriate that some accounting should be made to consumers who are such group members,so the benefit of the purchase can be evaluated. What is paid, by whom and for what,should be visible in terms similar to those used for disclosure to a buyer.

2.8 THE ROLES OF INTERMEDIARIES

2.8.1 An Overview

From the analysis so far it will be apparent that transactions between an insurer and an insured involve a complex and divergent set of interests on both sides, surrounding the delivery of a complex intangible financial service. The role and activities of intermediaries must be seen in that context.

Insurers' selling systems can be broadly classified as general agency (including brokers), direct writing and mass merchandising. [1] Those using the general agency system usually will also sell through brokers. Direct writers typically use exclusive or captive agents for all, or nearly all, their business. In some cases, insurers use direct writing in some geographical areas and general agents in others. Mass merchandising firms use advertising in print media to solicit written inquiries which are in theory followed up by employees of the insurer who are not paid by commission. In fact, pure mass merchandising so far is rare; advertising is usually followed up by exclusive agents who receive a commission on sales.

Insurer's claims settlement systems require someone in the organization responsible for claims settlement. This person acts on information gathered by adjusters who are the field investigators. Adjusters are sometimes given limited authority to make agreements on, and even to pay claims. Otherwise authority to accept a claim, and pay it, rests with the employee of the insurer responsible for claims settlement. Adjusters may be unlicensed

employees of an insurer or licensed independent adjusters who serve various insurers on a case by case basis for a fee. Any insurer will use an independent adjuster some of the time since some independent adjusters become specialists in dealing with certain kinds of losses. Sometimes in establishing the value of a loss other experts or specialists are called on. Some of these specialize in insurance matters; others do not. Some are licensed under other statutes, but none are licensed under the insurance regulatory system.

One theme that turns up at several points in the analysis of the roles of intermediaries is that there may be scope for the development of increased efficiencies in the industry. If the regulatory system did not support the present structure so rigidly, new lower cost delivery systems might develop. There is limited scope for reducing total costs by reducing agent's commission rates. What might happen though, is the development of lower cost systems that do not use agents as we now know them. This development would depend on recognition that there are segments of the market which could best be served by simpler systems of distribution. Two technical factors might facilitate such a development.

- standardization of forms and disclosure of information for commonly used kinds of insurance
- the use of computer terminals with analytical programs in the processing of applications

These factors combined with possible use of the variety of financial institutions with branch systems in the Province, offer

opportunities for new approaches. The present definition of and licensing of intermediaries in the industry inhibits experimentation by the industry and by other industries in the distribution of insurance.

2.8.2 Agents

From the insurer's point of view, the principal role of agents is to find for the insurer new customers to join the pool of risk, or to induce those already in the pool to increase the amounts they insure for, or to insurer against additional risks.

From the agent's point of view, especially if he be a general agent, his main role is finding a satisfactory insurer to insure the needs of the clients he looks after.

From the consumer's point of view, for individual buyers the agent is the person he calls when he wants insurance, and for commercial buyers the agent, if he be a larger general agent, is indistinguishable from a broker.

When an agent works exclusively for one company, his principal function is to sell the contracts of the insurer he works for. This does not by itself prevent him from doing a good job in fitting the contract offered by his insurer to the needs of his clients and adjusting these contracts from time to time as the client's needs change. However, it does prevent him from dealing with two important ingredients in an insurance buyer's decision process: price and claims settlement.

Price

> An exclusive agent does not serve his insurer well if he redirects prospective clients to another insurance company because the price is lower for similar coverage. Indeed, given the nature of his relationship with the insurer, he has no reason even to inquire whether another insurer's prices are lower.

Claims settlement

> It would not be part of the exclusive agent's role to direct his potential customers to those insurance companies who may have better records for claims settlement than his own.

General agents are more numerous than exclusive agents and they are used for selling insurance by more insurers. There are a number of reasons why an insurance company may choose to sell insurance through general agents rather than directly through its own employees.

> The amount of insurance written in a geographical area by an insurer may simply be too small to support an exclusive agent by commission.
>
> The general agent arrangement is particularly suitable to insurers who hope that some features of their contracts or ways of doing business (price, reputation for claims settlement or breadth of coverage in the contracts) will give them competitive advantage over other insurers.

There are both advantages and disadvantages for the consumer from the general agency system. Advantages are that:

- The existence of the general agent can bring to the consumer services of the small insurer who might not otherwise get wide distribution for his contracts.
- The general agency system reduces barriers of entry for new insurers, which is a necessary but not sufficient condition for competition in the industry. The barriers to entry for new insurers and the barriers to growth for small ones are reduced because selling costs are made largely variable.

On the other hand, the general agency system inhibits the development of new systems of selling which might result in cost economies in selling costs. Any significant future gains in the reduction of selling costs may well come from new systems of selling.

The growth of direct writers and mass merchandising of insurance is seen as a very real threat by both general agents and the insurers who use the general agency system. General agents see the possibility of losing their customers to exclusive agents selling for insurers who can offer lower prices; this has already happened to some extent. Insurers using general agents find themselves unable to switch out of the general agency system to try other methods without risking the loss of large amounts of their present business.

Most general agents are competing with exclusive agents to serve the needs of individuals, primarily for automobile and property insurance. A smaller number of general agents concentrate on serving business and institutional buyers, although they are likely to serve the smaller organizations in this segment.

The Report of the Steering Committee of the Agency-Company Operations Study in March, 1974, [7] suggests that the general agent serves on the average about a dozen insurance companies, but he places about two-thirds of his auto insurance with only three companies and about two-thirds of his property insurance with only three companies. It appears possible then, that the general

agent may do some selecting amongst insurers on behalf of his client. However, in many cases the choice amongst the three main insurers he deals with in a class will be made for considerations which may be irrelevant or contrary to the client's interests. For instance, different insurers may be accepting different classes of risk, or their target for new business in that area may have been met, or the agent's recommendation may be determined by the commission structure offered or the ease with which he can put the paperwork through one insurer rather than another.

The general agent may indeed advise his business customers in choosing amongst insurers he serves, or even from ones he does not normally serve, taking into account advantages in price or expected advantages in claims settlement or other factors that may be of use to the buyer. The agent may, to maintain his relationship with the client, act more in the insured's interest than in the insurer's. In these cases, the general agent is behaving very much like a broker. This seems more likely to happen with general agents serving business customers than those serving individuals.

Both exclusive and general agents are sometimes asked by the insurer to be the first point of contact when the insured has a claim under an insurance policy. In this case, the agent is being asked to act as an agent for the insurer as the recipient of claim documents. Simultaneously, in the interest of preserving his relationship with the insured, the agent may give strong supporting argument for his client's claim. This linking of the

selling and claims settling process is of value to the consumer. How often it happens is unknown. Intuitively, it seems probable that it occurs more often in smaller communities in the Province and with the larger agencies in urban areas. This service by the agent is really no more than that which any salesman interested in repeat business would be concerned about, in terms of the delivery of the product or service he sold.

The role of the exclusive agent is clearly that of salesman for an insurer, and he is likely to be perceived as such by the insured. The general agent's role is less clear because he serves several companies. This lack of clarity is important because two influences align the general agent's conduct with the insurer in a way that is not evident to the buyer. These two influences arise from the nature of the usual contractual arrangement between insurers and general agents.

An agent may be tempted to switch his business to an insurer for a higher commission rate for himself. The general agent is the 'owner' of a group of customers. A common clause in a general agency contract is that the insurer foregoes the right to communicate with an agent's client directly, for renewals or any other matter. (The two parties may agree, however, to contact by the insurer on claims or for direct billing.) The insurer is thus effectively prevented from switching his existing insureds from one agent to another or from a general agency system to a system where he

he deals with the insured directly. But the insurer can try to 'buy' business by offering a higher commission rate than other insurers do.

The other important element in the contractual arrangement between insurers and agents is the commission rate structure. It is common for an insurer to offer commission rate incentives to agents on a variety of bases. The commission rates may be scaled to offer higher incentives for an increased annual volume of insurance premiums or for lower loss ratios on business placed with the insurer. This creates powerful incentives for an agent to place insurance with an insurer for reasons that have nothing to do with the consumer's interest or benefit. Furthermore, the consumer has no clue that such influences are at work.

There are several conclusions arising from this analysis of the role of agents:

1. Insurers have a need to be served by someone selling on their behalf - displaying their wares so to speak.

2. Agents, whether exclusive or general, act on behalf of insurers rather than insureds. Their concern for the insured is no greater than that of any salesman who wants repeat business from a satisfied customer.

3. The term 'agent' is confusing to the consumer, because it does not make clear whose agent he is. Any changes in the Act should make it easier for the consumer to identify the role of the agent clearly.

4. There is no problem in an insurer offering inducements to those selling for him, provided there is no confusion in the buyer's mind that he is facing a partisan seller rather than an adviser with the insured's interests at heart.

2.8.3 Brokers

The role of the broker differs little in form from that of a general agent. By definition in the Act, he places insurance with an insurer rather than solicits for an insurer, and he is not required to be sponsored by an insurer, as is an agent. The most important difference, however, is in how a broker views himself. He represents himself as serving the insured or potential insured. There are two principal ways in which a distinctive service is offered:

> One is that the broker himself, rather than the insurer, will analyze the insured's needs. He may give actuarial or engineering advice on how the insured can arrange his affairs best to reduce his need for insurance protection and therefore reduce his risk and resulting insurance costs.
>
> The second area of distinction is that a broker considers the rates offered by several insurers each time a contract is to be placed.

The skill with which a broker does either of these functions varies. The service offered to a customer by a broker may indeed be no better than that offered by a general or even an exclusive agent. If the broker regularly gets prices from only two or three insurers, he will know no more about available rates and therefore can be of no more service than the general agent who is associated with two or three insurers. If a person calling himself a broker gives scant consideration to assessing the insurance needs of the insured it may well be that the insured could have been better served by a conscientious exclusive agent. Furthermore, a number of general agents regularly offer the two distinctive services ascribed to brokers above.

A potential buyer may be justified in expecting to be better served by a broker on the issues of price and the arrangement of his affairs to reduce risk, than by an exclusive or general agent. A major anomaly is that a broker's remuneration is usually set by the insurer as a percentage of that premium that does not vary among contracts of the same kind. Historically this was apparently intended to prohibit a commission rate paid to one broker being different from that paid to another on a given policy from an insurer. Since the percentage rate can vary amongst insurers, a broker (as well as an agent) faces some economic inducement to direct his customer into an insurance contract that may be less than optimum for the insured. The use of percentage commission rates gives the broker an incentive to oversell - through covering for higher than necessary amounts or suggesting lower deductibles. Furthermore, the broker may also be faced with the same volume or performance incentives that are offered to general agents. So, the same question arises as with the general agent - on whose side does the broker really stand?

Another function brokers may perform is the preparation of the application for insurance and perhaps even the writing up of the insurance contract document. In performing this task, the broker has the appearance of acting for the insurer. Other tasks which could be similarily construed are the collection of premiums from the insured and the giving of binders or cover notes.

The combination of the way a broker receives his remuneration and the role he plays in the tasks he performs for the insurer, detracts from the concept that the broker plays a role exclusively on behalf of insureds.

The main conclusions to be drawn about brokers then are:

1. When insureds have a need for experts to represent them in selecting and buying insurance coverage, the terms and amount of payment for the help should be settled solely between those two parties.

2. When the broker's remuneration is set by the insurer for a transaction it does not appear possible for the broker to be committed exclusively to the interests of the insured.

2.8.4 Insurance Adjusters

Earlier in the analysis it was pointed out that dissatisfaction often arises from a discovery that what is covered, or the amount to be received when a loss occurs, are less than was expected by the insured. Part of the gap between expectation and result must arise from a lack of understanding or clarity at the time the insurance is sold. But it cannot be assumed that the process of settlement is without problems. We must look at the claims settlement process itself, and the role insurance adjusters play in it.

When an insured has a claim to file against an insurance company, he may need help with several tasks:

1. He must prove that there was a loss
2. He must find out whether the loss was of a kind that the insurance contract covers.
3. He must estimate or evaluate the amount of the loss and how much of it the insurance will cover.
4. He must file a claim.
5. He may have to negotiate with the insurer if the insurer does not accept the claim as filed.

The complexity of each of these tasks can vary from the very simple to the very difficult. If the insured and the insurer cannot resolve their differences on these issues, the matter will be settled through arbitration or the judicial process. However, not all matters are so difficult to resolve that they need the intervention of an arbitrator or judge - nor do they involve enough

money or doubt to justify this form of conflict resolution. The insurance business simply would not work if most settlements were not agreed to by the parties directly. What we have to look at then is not the process that goes on when the parties cannot agree but rather the processes through which the parties come to agreement.

To verify whether there was a loss, what kind and how much, the insurer sends an adjuster into the field to deal with the insured claimant. The adjuster's first job is to find out whether there was a loss, by a physical inspection, or by gathering oral and written information. Since the contracts are usually worded to limit the coverage to losses that arise from specific causes, the adjuster must next consider how the loss occurred. Finally, he must decide on the amount of the loss. To determine this, he must not only refer to the insurance contract, which sometimes specifies how the loss is to be measured, but also he must have a knowledge of values.

In approaching these questions the adjuster acts not as an adjudicator between the insurer and the insured, but rather acts for the insurer. When the adjuster is an employee of the insurer, whom he is acting for may or may not be clear to the insured. When the adjuster is an independent adjuster there is even more opportunity for role confusion. The use of the term 'independent adjuster'and the role adjusters adopt in helping the insured make his claim, obscure from many insureds the fact

that the adjuster is acting for the insurer. At the same time one must recognize the important role adjusters play in keeping costs down for all insureds by detecting and preventing improper claims. The point is not that the role is unnecessary, but that it must be clear to the insured what the role is.

The pressures an adjuster can be under to decide against the interests of an insured add to the problem.

> When the management of an insurer has adequate capital, is receiving an adequate flow of new customers with well balanced risks, and is having good experience with his underwriting losses, the pressures for it to deny proper claims are minimal. However, if the insurer is having an unhappy experience with any of these factors, the temptation to pursue a short term remedy in its own interest by reducing the losses paid out must be very great. The nature of the adjuster's position is such that organizational pressure will fall on him to reduce the amounts paid out in claims.

Under the present system, adjusters who are salaried employees of an insurer are not licensed; those who are not salaried employees of an insurer are licensed as independent adjusters. To the extent that licensing procedures are intended to assure the public of standards of performance and conduct, the difference is hard to understand.

When there is a gap between what a claimant thinks he is entitled to and what an insurer thinks he should pay, bargaining is the most commonly used form of conflict resolution before going to the courts. The insured may bargain directly on his own behalf, or he may retain a lawyer. He can call on the services of an independent adjuster (except in auto claims), although this is an option which is seldom used. It may be that few insureds

are aware of the availability of adjusters for this purpose, perhaps because the independent adjuster is perceived as, and perhaps because he perceives himself as primarily working for insurers.

Since 1935, the Act has prohibited adjusters from negotiating for or advising insureds on automobile claims. While it is obviously desirable to prevent ambulance-chasing, it is not clear that the public should be denied this source of help entirely.

If there were an identifiable and qualified group of people whom insured claimants perceived as available for consultation on and help with claims within all classes of insurance, it seems possible that there might be more negotiated settlements at a lower cost. The settlements might also become fairer in the long run, since equal expertise would be available to both sides.

In the bargaining contest, it would appear that the relative power of the contestants is far from equal. The insurer may be far more willing to face the possibility of legal fees and court costs than the insured is, because these have already been provided for in his expectations of what will have to be paid out of the pool. The insured on the other hand, sees such costs as a pure reduction of his wealth if he loses. In these circumstances, it would be desirable to see much greater use made of the system of arbitration that is now provided for in the Act. The system could be expanded to deal with more than the mere quantum of the loss. This could provide a less expensive

form of conflict resolution than litigation. There would be an area where some of the expertise appropriate to an adjuster would be similar to that appropriate to an arbitrator specializing in insurance claims.

The role of adjusters and the problem of conflict resolution have so far been considered only in the case of disputes between an insurer and an insured. There is one other type of situation where adjusters are presently involved, where the insured is not an antagonist. This is where the insured and the insurer are in agreement or have settled the insured's claim, and the insurer is making a claim on a third party by way of subrogation; or a third party is making a claim against the insured. In these cases, the claimant and the insurer (rather than the insured and the insurer) are in antagonistic roles. The needs of the public and the potential roles of independent adjusters can be equally relevant in these cases.

From the point of view of the buyer of insurance, the purchase of an insurance contract and the settlement of a claim are not separable problems. The settlement of a claim is in fact a major part of what he buys when he pays for his insurance contract. The separation of functions, by having specialists in the selling of contracts and specialists in claims settlement, is understandable from the point of view of an insurer who is organizing tasks within his firm. But this separation of function is not self-evidently useful from the consumer's point of view. I have observed that some insurance broker firms have on their staff employees who have been adjusters

or who have had experience in the adjustment process as employees of insurers. It seems likely that this practice is a response to the needs of the consumer for a single place he can go to for advice on his total insurance problem. This suggests that the ultimate insurance adviser for the public may be a person or organization qualified to assist with both the buying process and the claims process.

From this analysis of the role of insurance adjusters and of the claims settlement process there are a number of conclusions:

1. There is a need for experts in the settlement of claims to serve insurers.

2. There is a need for experts in the settlement of claims to serve insureds.

3. There may be a place for independent experts available to both parties as referees or arbitrators.

4. The term 'independent adjuster' is likely to be misunderstood by the public to mean a referee. Its use as a term to describe people who act primarily for insurance companies but are not their employees should be discontinued.

5. Use of the presently available arbitration process should be encouraged and promoted when there are disputes, and its scope should be enlarged.

2.8.5 Consultants

The analysis so far suggests that there are problems connected with insurance from the point of view of the consumer, especially the business consumer, on which he could be expected to need,and be willing to pay for,independent expert advice. Since the insurer has considerable expertise on these matters, it is natural that the uninformed insured might like to get some independent advice so that he can feel satisfied that what the insurer is offering makes sense in terms of his needs. A necessary, although not a sufficient condition, for the insured to get such advice is for him to pay a consultant to work exclusively for him on the question in hand. An increasing number of people who call themselves consultants have emerged in the insurance field.

The buying needs listed on page 31 in the section on 'The consumer's needs' are mainly met by the services offered by brokers and some general agents. What keeps a broker or agent from being a consultant in the ordinary sense of the term is that:

1. He gets paid by a commission set by the insurer.
2. He performs services for the insurer - premium collection, preparation of forms and documents for applications and claims,and the giving of binders.
3. An insurer may have an undisclosed ownership relationship with a broker or agent firm.

Claims settlement needs can also be met for the most part by services available from adjusters.

There is no statutory definition of the term consultant, including a consultant in the insurance field. To determine what a consultant is, one has to look at ordinary language and customary business usage. Two characteristics the public expects in a consultant are:

1. A degree of independence and an absence of monetary incentive for the consultant to advise his client in one direction or another.

2. A level of skill adequate to the task.

The question of skill levels will be discussed later in this report. The issue of independence is uniquely important to the role of insurance consultant, and will be discussed here.

It is a violation of the simplest good sense to allow a person to call himself a consultant to an insured or potential insured if the person is in the same transaction being paid for services rendered to an insurer. The unique characteristic of a consultant is his exclusive commitment to the interests of his client. A necessary condition for this commitment is that the consultant be paid only by the client.

If the role of insurance brokers, and that of general agents who act like brokers, were altered to ensure their independence and skill, their role would be that of an insurance buying consultant in the fullest sense.

Is there room for other consultants? Two areas in insurance buying have developed where the term consultant is sometimes used:

> There are people who offer their services as consultants in the field of employee benefit programs. Most of such people appear to have actuarial backgrounds or an association with an actuary. This function has arisen in part because slight changes in the structure of benefit plans may have a very large impact on premiums as a result of changes in the expected payout of benefits. An actuary is particularly qualified to estimate the impact of variations in the terms of a plan. The buyer may wish to review several alternatives. There is a limit to how much work an insurer is prepared to do in looking at alternative plans if he is not certain of getting the business from the buyer. Besides the expected payout, the other element in premiums is the mark-up. Since this can vary significantly from company to company, the insured may be reluctant to commit himself in advance to a particular company. Thus he may require advice even before he approaches an insurer.
>
> The other kind of consultant that has emerged is an 'estate planning consultant'. Here the person calling himself a 'consultant' often turns out to be a licensed life insurance salesman. (This is so because others such as lawyers and chartered accountants who become engaged in estate planning consulting, are not allowed to hold themselves out as specialists.) 'Estate planning consultants' have not been included in my estimate of the number of consultants in the other-than-life insurance field. They are only mentioned in this report because they are often also licensed to sell accident and sickness insurance and because they are such a glaring example of the misleading use of the term consultant.

There is a real need for these two kinds of consulting. Insurance consulting is a legitimate and necessary service providing there is the requisite independence.

The question that arises is whether it is possible to draw any meaningful distinction between the possible role of a broker as a true insurance buying consultant and others who may

offer consulting services in the buying process. Of the buying functions described earlier, there are some that are central to the broker function and for which persons with other skills are not as well qualified. These functions are:

- obtaining quotations from insurers for specified coverages
- negotiating terms and prices with insurers, and
- placement of insurance

It might be possible for a role to develop for persons who offer special qualifications on other aspects of the process, but who are not qualified or prepared to take responsibility for above three aspects of insurance buying.

In the function of claims settlement, it would appear that those who are now independent adjusters would have the broad skills required to offer themselves as consultants to insureds. The essence of the adjuster's role as a consultant would be to help the insured with all those claims settlement needs identified in section on 'The consumer's needs'.

There are yet other occupations which are also involved in the claims settlement process. Lawyers, for instance, have a right to act for an insured on any of the issues involved in claims settlement. Doctors, art appraisers, real estate evaluators, construction costs estimators and auto repair shops all have expertise which is indispensible for insureds in evaluating some losses. All these occupations can be distinguished in two ways - any expertise they may have developed on insurance matters is secondary to other expertise

they possess; none is exclusively or even principally involved in the insurance industry.

In these cases, their value in insurance matters is their expertise in their principal field of activity. Therefore, it would not seem to be necessary for the insurance regulatory system to concern itself with these kinds of consultants.

It appears that there is developing, as an offshoot of the auto repair service, a form of consultant which is principally concerned with the insurance business. This offshoot is the appraiser of automobile collision damage for insurance purposes.

There does not appear to be any inherent objection to the existence of automobile appraisers or other new specialized roles. Yet where anyone carries on an occupation offering services to the public mainly for insurance purposes, it would seem logical that their activity should fall within the insurance regulatory system insofar as some general rules of conduct are concerned.

At the present time, it is probably appropriate to think of setting licensing, rules of conduct and qualification standards specifically for automobile appraisers. It may not be necessary to go so far for buying consultants who do not perform the central functions a broker does. But even they should be obliged to follow a general code of conduct applicable to all in the industry. These judgments are made on the basis of some general views on licensing, responsibility and qualifications which are discussed later in the analysis.

There are a number of conclusions that can be drawn from this consideration of the roles of consultants:

1. The consumer has a need for advisers who are independent and have no monetary incentive to advise the client in one direction or another, and who have skills adequate to the task.

2. If brokers were paid by insureds at rates negotiated between them, there would be no significant difference between the present role of a broker and the concept of the broker as an insurance buying consultant.

3. No one in the insurance business should be allowed to call himself a consultant unless he receives his compensation entirely and exclusively from those he is advising in a transaction and unless he is technically competent to give the advice he holds himself out as being able to offer.

4. All people who hold themselves out to the public as offering special services or advice primarily for insurance purposes should fall within the regulatory system for some general rules of conduct.

5. Whether separate licensing, rules of conduct and qualifications within the regulatory system should be established for specific occupations will have to be decided on from time to time. One occupaiton that now can be considered for such regulation is automobile appraising.

6. The regulatory system should be flexible and adaptable in identifying the roles to be governed and the standards that are to be applied. It should not inhibit the development of new forms of consulting specialists.

7. People whose advice is used in the insurance industry because of their primary skills in some other occupation do not need to be regulated within the insurance regulatory system.

2.9 LICENSING AND QUALIFICATIONS

In a major way the present regulatory system depends on licensing. Several classes of activities in the insurance industry are licensed. In order to evaluate the present system and alternatives, it is important to identify the objectives of licensing. Then one can assess whether the objectives have been achieved and whether there are other impacts of licensing that may or may not be desirable.

An occupation may be licensed for one or more of the following purposes:

1. To raise money for the licensor.
2. To permit undesirable practices to be traced to a licensee.
3. To create a restricted right to follow an occupation so that suspension or withdrawal of a license is an imposable penalty.
4. To restrict the right to carry on an occupation to persons with predetermined qualifications.
5. To control the numbers of persons who may carry on an activity for a variety of reasons, including inreasing the profitability of the activity for those already licensed.

A licensing system may achieve some of these results whether or not they were the primary purpose. For instance, if the practice of an occupation is restricted to persons with qualifications deemed to be desirable, the intention may be to ensure the level of qualifications, but a consequence may be to restrict the numbers who practice. Such a restriction creates a

barrier to entry of competitors which in turn creates scarcities which drive up prices or fees for the occupation. Even without the scarcity, if the attainment of qualifications has a cost, potential practitioners will not take up the business unless anticipated prices or fees are high enough for them to get a satisfactory return on their investment of time and money. Thus licensing which requires qualifications increases costs to the consumer by creating a scarcity, either deliberately or inadvertently.

The question of producing revenue for the licensor, is in general beyond the scope of this report. One possibility worth exploring is the setting of license fees high enough to cover the cost of the whole administration of licensing, qualification setting and disciplining. This reallocates the cost of regulation back to the beneficiaries - the consumers of insurance.

Tracing a licensee and penalizing by suspension or withdrawal,are necessary tools for administrative control. They are minimum objectives for a regulatory system aimed at consumer protection.

Why should minimum qualification be considered? The usual argument for qualifications, and a valid one, is that for a technical service the recipient needs some assurance of quality before the work begins. The customer may not see the quality of the service until after it is rendered. Even then, he may not be able to see or evaluate it. The argument is persuasive. The difficulty is in setting qualification standards that are directly relevant to the quality assurance problem.

In an earlier section of this report, segments of the insurance buying public with different needs were identified - some needs were simple, and some complex. The use of standard and non-standard contracts to meet the differences in need was considered. In looking at the roles of the intermediaries we saw that more than one way of delivering insurance services might be possible, each requiring different levels of skills.

If the level of skill required differs among cases, does one standard and one class of license for all make sense? I do not think it does. This conclusion seems as applicable for adjusting losses as it does for selling insurance. High performance standards and assurance of them can benefit some consumers. On the other hand, licensing requiring higher standards than are necessary is expensive, and the cost will be borne directly by the consumer through higher prices. Unfortunately, the cost may not be allocated directly to those customers who need a high level of skills. Increased qualifications should not be dismissed for the sole reason that they lead to increased cost. But one should be assured, before allowing increased qualifications to be imposed, that there are not other ways of achieving equivalent benefits for consumers.

Because of the variety in the kinds of transactions to be handled, I believe there may well be room for at least two skill levels, and thus two licensing levels. At the lower level, the objectives would be to trace undesirable practices to the perpetrators, provide a suitable penalty in a form of withdrawal of license, and assure financial protection for

premiums handled, but require only minimal skill qualifications. At the higher skill level those objectives enumerated for the first level would be required, but in addition, an attempt would be made to ensure that the licensee had a level of skill appropriate to a more complex set of problems.

From the consumer's point of view, there is no justification for deliberately restricting entry to the industry in order to increase the profitability of existing insurers or their intermediaries. At the higher level of licensing some scarcity induced increase in consumer cost may occur in the short run. At the same time one might expect off-setting service improvements or a reduction in total costs, combined with a better allocation of costs amongst consumers. There is also a reasonable prospect of lower costs to those buying insurance who use only lower skill levels.

There are several questions pertinent to the problem of qualifications:

- What kind of qualifications are appropriate for the practice?
- What tests are appropriate to see that the qualifications exist?
- What assurance is there that practitioners will continue to be qualified ?
- What institution or body is appropriate for applying the tests?
- What resources are there for practitioners to acquire and maintain the requisite qualifications?

Full answers to these questions are complex, and beyond this stage of my inquiry. To provide some insight into how these questions might be dealt with, it is useful to look at some elements of these questions as they relate to the other-than-life insurance industry.

Several kinds of qualifications may be considered:

- Objectively measurable characteristics
    - Examples are citizenship, and existence of a criminal record.
- Financial capability of meeting claims and penalties
    - Net assets owned or ability to be bonded are directly measurable attributes of financial capability.
- Knowledge
    - The kinds of knowledge usually relevant to the practice of an occupation are:
        - Retention of knowledge
        - Ability to generalize
        - Problem solving with familiar problems
        - Problem solving with unfamiliar problems
- Behavioural characteristics
    - Examples are honesty integrity and respect for rights of clients and competitors. These can only be measured indirectly in advance, by such techniques as asking for character references. They may be measured directly after the event, if there is an effective body for investigation and adjudication.

The choice of what to test for should be governed by the purposes of the qualifications. Because objectively measurable characteristics and financial capability are more directly, and therefore more easily measurable, use of these kinds of qualifications is tempting. If protection of insureds and insurers from the loss of premiums entrusted to an agent or broker is the prime objective, then a simple test of financial responsibility is sufficient.

> For a large majority of insurance transactions it is apparent that the prime qualifications required are indeed only simple honesty, limited financial capability, and a relatively low level of knowledge retention.

> A number of selling and claim settlement transactions require a much higher level of qualifications. The qualifications include capability of solving familiar problems. Testing for problem solving qualifications is relatively rare in any occupation because of its difficulty and resultant high cost.

Problem solving ability for familiar problems is what is usually meant by 'competence'. If competence is what is really required for the job, then to test only for knowledge retention offers at best a false sense of security and at worst a deception to the public. On the other hand, to require problem solving ability for the occupation when only honesty, or at most, knowledge retention is needed would be to impose a higher than necessary cost on the consuming public.

How long can one rely on the results of a particular set of tests? Tests can only show whether the qualifications tested for are met at the time of testing. This is a severe limitation where knowledge is chosen as the qualification. Relevant knowledge to be retained,conceptual frameworks for generalizations, and techniques for solving problems all change over time. Therefore, some provision may well be needed for periodic retesting if the process of testing for qualifications is to be effective. The administration and updating of periodic tests can be expensive. Should this expense be borne by the Government, or can it be shifted to the industry in some way? What bodies in the industry might appropriately undertake the testing process ?

Similar questions may be asked about the resources for acquiring knowledge. Community colleges may be an appropriate resource, but who will specify what is required and see that the specifications are kept up to date?

The problems of testing for knowledge and developing resources for its acquisition indicate some difficult decision areas for your Department in the future, if qualifications to be tested for go much beyond simple one-time objective measurements.

Another area that will continue to be difficult for the Government to cope with, except at a simple level, is conduct by participants in the industry towards insurance buyers and among themselves. When a government body takes a strong position on conduct it can gain a reputation for arbitrary interference in the rights of an individual to practice his business. Where it takes a weak position, it gives the appearance of giving protection without in fact being effective. There have been examples in Canada of governmental regulatory bodies that have had a strong impact on behaviour through moral suasion. Regulation in this style is relatively effective where the industry is responsive, and the problems are few in number and relatively simple. The long term trend appears to have been for the force of moral suasion to weaken as more and more rulings need to be committed to writing, and the disciplinary process needs public justification. Taking the long view, a trend to more numerous and more detailed formal rulings may be expected in your jurisdiction. The widening scope and increasing detail of the regulations will lead to increasing costs of administration and to increasing conflicts between industry participants and the Government.

Continuing direct involvement of the Government in questions of competence and conduct may also lead the public to expect more protection than can be delivered. Testing for qualifications can only affect the competence of performance indirectly, and the regulation of conduct can usually only achieve minimum standards. Yet, detailed Government regulation may imply to the public that many marginal or misunderstood activities are endorsed by the Government. Standard setting and testing for qualifications and surveillance of conduct are inescapable. The Government must be concerned about these issues. The question is, are there other ways to be concerned besides direct involvement?

Self-regulation by the industry is a possibility that has to be considered. One argument against self-regulatory bodies, is that they can be self-serving. To overcome this possible weakness, there has developed the idea that self-regulatory bodies might formally include within their organization representatives of 'public interest' or 'citizen input'. Experience with public interest representation is short and inconclusive in Canada so far.

The concept of 'public interest representation' may be a useful addition to a model for self-regulation in the insurance industry. It might also provide a way for the Government to show its concern and maintain its interest in the regulatory process by playing the role of evaluator and critic of the self-regulatory body.

The self-regulatory model could provide a means of pushing the problems relating to discipline and qualification testing onto the industry. There might be additional benefits in that the cost of regulation could be kept out of the Government budget. Finally, a self-regulatory body might be much better equipped to meet the need for continual revision of standards of conduct and for discerning the shades between practicable and crippling standards. This could avoid the difficulties a government department often faces in keeping up to date with changes in industry practices and the public's expectations. It might also reduce the area for conflict between participants in the industry and the Government.

Is there any hope of inducing the industry to regulate itself? The answer at this stage is uncertain. There are several associations representing different segments of the industry. Some are already engaged in educational activities and questions of conduct. Some, in both the life and other-than-life fields are interested in self-regulation and some are not. Agent groups particularly have shown an interest in a system which would allow effective self-regulation. Some insurers and insurer groups in both segments of the industry have initially shown a negative reaction to the idea. To settle the question would take considerable further study and exploration of the issues with industry organizations. The potential rewards seem worth the effort.

The main conclusions from this section are:

- The setting of qualifications is difficult, costly and may not be wholly in the consumer interest, but on balance, it remains inescapably part of the control system.

- The setting of qualifications, examination for them and their revision is a continuing process in which conflict is inherent - the consumer, insurers, agents and others have a limited area of common interest in the process and many areas of conflicting interest. Some structure is necessary within which common interests can be continually defined and adjusted and the conflicts can be resolved.

- The same set of qualifications is not necessary for all kinds of transactions.

- There could be significant advantages (effectiveness and cost allocation) to the Government and the public interest in transferring to the industry the job of setting and testing for qualifications of knowledge and conduct.

- It may be possible to induce several groups to participate responsibly in self-regulation in the industry. This might increase the effectiveness of your Department, but it would require it to play a different role as evaluator and critic.

2.10 WHO IS TO BE HELD RESPONSIBLE - COMPANIES OR INDIVIDUALS?

One of the difficulties in considering legislation for the regulation of the insurance industry is that in several cases the same function may be performed by either an employee, or by a quasi-independent 'person', or by a truly independent 'person'. The 'person' involved may be either a company or an individual.

> For example, consider the role of the adjuster. An insurer may have its own employees which it calls 'adjusters', whose job is to meet with insured claimants or third party claimants to settle all questions relating to the claim, and to make recommendations to the insurer's claims department for settlement. This same function may be carried out by an individual who normally works for several insurers and does the work for a fee. It is not unusual for an adjuster to incorporate. Then the business of adjusting is performed by the corporation through its employees.

> Similarily the application for an insurance policy may be prepared by an insurance agent who is an exclusive employee of the insurer, by a general agent who acts for a selected group of companies or by a broker who considers himself independent of any insurer. Just as the adjuster who is not an employee may incorporate and use employees, so may the general agent and the broker.

Several issues arise from the complexities described above:

> Does one attempt to regulate the performance of the task regardless of whether it is to be performed by the insurer or someone independent of him?

> Does one attempt to regulate the individual performing the service, or his employer, or both?

> Are the purposes and processes of regulation the same whether one is regulating the corporation or the individual?

In some occupations attempts are made to regulate the competence of individuals on entry into the occupation. So far as I know,

no serious attempts have yet been made in the same sense to regulate the competence of corporations, other than on the basis of financial competence such as tests for the liquidity.

> In rate hearings of organizations that have been awarded monopolies, e.g. communications, transportation and energy, the question of competence is becoming more often an issue in the hearings, in terms of economic performance and quality of service. The regulation of competence in those areas is extremely expensive both for the regulator and for the regulatee and so far has been confined to businesses where the regulatees are relatively few in number. I do not see room for regulation of performance of companies in the insurance industry.

One may still desire to regulate corporate behaviour - the real question is whether it can be done successfully. In practice, it is simple enough for an organization to produce evidence that it has forbidden undesirable behaviour, at the same time that it has consciously or unconsciously created pressures to induce that behaviour. A social scientist could analyze the functioning of a group and establish that the inducement to certain behaviour exists in the organization in spite of its formal declared policies. But such evidence would be of doubtful value in a prosecution for failure to follow prescribed behaviour.

This difficulty suggests that regulation of a corporation must be supplemented by regulation of the competence of the individuals who are allowed to perform certain acts for the corporation.

To license and control for competence of individuals who are employees, one is faced with another set of problems. What protection is given to the public by testing the competence of

an individual if he is thrust into the position where a corporate employer may exert pressure on him towards incompetent or undesirable behaviour? Examples of this kind of pressure are easy to imagine:

- An adjuster who is an employee can be put under pressure to deny claims or portions thereof because it benefits his employer to do so.
- An employee who is an exclusive agent,or a salesman of an incorporated general agent or broker, can be induced by the commission structure to encourage sales of one kind of policy over another.

From an insurers point of view, these may be legitimate ways to motivate employee behaviour in directions desirable to the organization.

No set of rules for corporate behaviour can completely overcome the kind of organizational pressures that can be exerted on an employee to do something different from what the regulatory body might wish. However, setting rules of behaviour, and the threat of withdrawal of the right to carry on an occupation, for employees may create significant counter-pressures. Such counter-pressure is an important objective of licensing individuals in addition to the licensing of corporations. This licensing is a supplement to whatever set of rules and sanctions are established for corporate behaviour.

The conclusions I draw from these considerations are:

1. The regulation of corporate organizations for skill and competence is not feasible.
2. The regulation of corporations at the level of fraud and dishonesty is feasible, necessary and desirable.

3. The regulation of corporations in terms of requiring them to carry out specific procedures in certain circumstances is possible, and can be worth doing if the procedures themselves provide some protection to the public.

4. The licensing and regulation of individuals who are responsible for carrying out certain acts of the corporation is feasible. The threat of withdrawal of an individual's license can provide some counterbalance to possible corporate pressures which are contrary to the consumer's interest.

3. CONCLUSIONS AND RECOMMENDATIONS

3.1 CONCLUSIONS

The analysis in this report has been complex in part because the nature of the service of insurance is hard to define and in part because the industry distribution system has many components, among which the relationships are not self-evident. Now the conclusions from the analysis must be woven together.

The present Act and Regulations need substantial revision to fit better the realities of industry roles, to encourage certain practices (some of which are now assumed to be prohibited) and to promote the consumer interest. Before this can be done, there are many issues of Government policy to be resolved.

The roles and interests of the parties to the distribution of insurance are confusing to consumers. The titles used by various participants and the way commissions are set and paid all lead to confusion about who acts for the consumer, and who for the insurer. Commission arrangements may work to induce behaviour contrary to the consumer's interest.

The consumer does not have the information he needs to make a rational buying decision. Information deficiencies occur in the areas of perils covered by the contract, claims settlement practices of the insurer, price disclosure and inability to relate cost information to expected benefits.

The claims settlement process can leave the consumer feeling frustrated and relatively helpless. He may find his coverage more limited than he thought, or the basis of estimating a loss different from what he expected. There are powerful incentives that can operate on insurers to pay lesser amounts than they should. There is no effective procedure short of litigation for a consumer to resolve differences with insurers. Procedures for conflict resolution which would make the contest more even and lower its cost must be encouraged.

The evolution of roles and the development of new structures for serving the consumer are inhibited by the present regulatory system. The present rules on commissions and licensing prevent the development of a class of advisers exclusively committed to the consumer, to interpret information and to negotiate on his behalf.

Prices to the consumer may be higher than necessary because the present regulatory system inhibits competition in selling costs. There are possibilities for lower distribution costs from changes in the system. The industry is sufficiently competitive that these cost reductions will be passed along to the consumer.

Prices may also be higher than necessary because the insurer is not required to disclose separately how much of the premium is for expected benefits and how much is the insurer's mark-up. Companion information about risk classification and claims settlement practices is also needed.

An important policy question is how far the Government is prepared to go in direct involvement in these areas:

- determining industry structures;
- setting, examining for, and administering licensing standards;
- specifying educational requirements;
- setting rules of conduct and administering their enforcement;
- establishing standardized insurance contract terms to improve the consumer's understanding;
- establishing appropriate disclosure rules.

The problem is not just how to settle these questions once and for all. Rather, it is to provide a structure within which these areas can receive continuing attention based on an intimate knowledge of changing industry practices and consumer needs. For the Government by itself to take on these tasks in an effective way would require a much enlarged

and very different kind of Department from what exists now. I sense that an enlarged Department with a broader range of activities is not a desirable policy option. It is necessary to consider alternatives.

Increased government intervention would not be welcomed at this time by the industry. A consensus at this time on alternatives is also unlikely, because there has been so little public discussion and analysis of the problems. My enquiries and discussions of problems and alternatives with various industry groups has prompted some to promote to you proposals along the lines discussed with them. But the proposals I have seen suffer from an incomplete understanding of the industry problems discussed in this report. It is very important that the issues and problems be thoroughly exposed for analysis and criticism by your Department, the industry, the press and the public.

At the outset I explained that much of the analysis would be only informed hypothesis. There are some areas where it is possible to achieve greater reliability of information and insight into problems through specialized studies:

- development of a model statement of minimum disclosure requirements including expected benefits, mark-ups and other information about the service offered by the contract.
- development of some model contracts
- development of model sets of rules of conduct for industry participants
- a study of the variability of insurance premiums, including the variability of expected benefits and mark-ups, and the relationship of these to claims settlement practices.

- studies of the industry structure, including numbers and distribution by size, and geographic location for insurers, brokers, agents, adjusters and others.

3.2 RECOMMENDATIONS

Based on the foregoing analysis, I make three broad recommendations:

> The goal of the regulatory system should be to control behaviour and performance and not industry structure. The primary functions of the regulatory system should be to ensure that usable information is available to the consumer and to prevent deception by any party. A major change from the present regulatory system should be to give the industry maximum flexibility to develop different ways and structures for offering services, and devising product innovations.
>
> The insurance industry needs further study in several specific areas. Studies of both the life and other-than-life segments should be carried on with the expectation that a large measure of integration will be achieved in the rules of conduct and rules of disclosure.
>
> This report and any further studies should be published. Some mechanism should be established whereby discussion by interested parties is stimulated; comments, criticisms and submissions should be gathered before revision of the Act.

My fourth report will go further. Going on from conclusions and recommendations in the first three reports, there will be more detailed consideration of solutions to issues that have been raised. There will also be a discussion of a strategy for dealing with the process of implementing change.

NOTES AND REFERENCES

(1) In this report the term 'exclusive agent' is used to identify an agent who serves only one insurer, while the 'general agent' is used for an agent who serves more than one insurer. It is recognized that in industry terminology the term 'general agent' often refers to an agent in a territory who engages other agents or sub-agents to operate in parts of that territory. This form of organization is understood to be more common in other parts of Canada than Ontario. Therefore the term 'general agent' has been appropriated in this report for the special meaning defined above.

(2) Adapted from E.P. Newfeld, The Financial System of Canada, Macmillan of Canada, Toronto, 1972, p.52.

(3) Derived from G.D. Quirin, Competition, Economic Efficiency and Profitability in the Canadian Property and Casualty Insurance Industry, Insurance Bureau of Canada, Toronto, 1974 and 94th Annual Report of the Superintendent of Insurance for the Province of Ontario, Business of 1972, Toronto, 1973.

(4) E. P. Newfeld, op. cit., p. 284.

(5) 94th Annual Report op. cit.

(6) E. P. Newfeld, op. cit., p. 284.

(7) Included in a submission to the Minister of Consumer and Commercial Relations dated May 28, 1974 by Ontario Insurance Agents' and Brokers' Association on Standards for Self-Regulation.